

# Mercia Asset Management

H122 results

## Sustainable model remains undervalued

After 18% growth in FY21, H122 assets under management (AUM) was up only marginally to c £948m, with nine exits resulting in distributions to investors of £39m. Net assets and NAV per share rose by 6% during the period to £186.4m and 42.4p, respectively. Revenue (excluding £2.6m of performance fees) increased 21% y-o-y to £10.1m (88% contracted and recurring) with EPS rising 35% y-o-y to 2.53p, leaving the group with net cash of £52m. Confidence in the sustainability of Mercia's hybrid model allowed the board to triple the interim dividend to 0.3p per share - we estimate that the shares might offer a prospective FY22 yield of c 2% assuming a more conservative uplift in final dividend than in FY21. Mercia trades on a P/E of 7.3x annualised H122 EPS and at 0.87x H122 NAV, before considering the incremental value of the third-party funds business (we estimate 7p per share at 4% of funds under management).

Period end	Net cash* (£m)	Direct investments (£m)	FUM (£m)	NAV (£m)	NAV per share (p)	P/NAV (x)
03/20	30.2	87.5	658.0	141.5	32.1	1.15
09/20	24.9	101.6	722.0	149.9	34.1	1.09
03/21	54.7	96.2	764.0	176.0	40.0	0.93
09/21	52.1	110.3	762.0	186.4	42.4	0.87

Note: \*Includes liquid securities but not funds held on behalf of EIS investors.

## H122 results: 21% revenue growth, dividend tripled

Revenue (excluding £2.6m of performance fees) increased 21% to £10.1m (H121: £8.4m, nil performance fee) and PAT increased 35% to £11.2m (H121: £8.2m). EPS increased 35% to 2.53p (H121: 1.87p). This strong performance left the group with cash and short-term liquidity investments of £52m (FY21: £55m). With increasing confidence in the sustainability of Mercia's hybrid investment model, the interim dividend was trebled to 0.3p per share (H121: 0.1p).

## 14% IRR since IPO, M&A anticipated

Management set out its strategic goals for 2022–24 in its Mercia 20:20 vision, including average annual growth in AUM of 20% over the period (closing AUM of £1.6bn by FY24) and average PBT of £20m per year, or total PBT of £60m over the three-year period. Mercia has delivered a direct investment portfolio IRR of 14% from its IPO in 2014 to 30 September 2021 and annual growth in NAV per share of over 24% over the last two years, following completion of the acquisition of the Northern VCT fund management business. Having demonstrated the success of this acquisition, we believe Mercia has the means (H122 cash of £52m) and the rationale to target further M&A in 2022 without recourse to the markets.

## Valuation: 0.87x NAV, 7.3x annualised P/E, 2% yield

Mercia trades on an H122 NAV of 0.87x, towards the bottom of our field of direct investment peers. This is even before considering the incremental value of the third-party funds business (we estimate an additional 7p per share at 4% of FUM). However, specialist asset managers trade at multiples of NAV as their valuation is increasingly referenced to earnings multiples. Mercia trades on a P/E of 7.3x annualised H122 EPS (vs peers on 19x FY21 P/E) and, after the trebling of its interim dividend, we estimate Mercia will offer a prospective FY22 dividend yield of c 2%. Given the strength of Mercia's business and its structural profitability, we believe Mercia remains undervalued at these levels.

## Investment companies

14 December 2021

**Price** 37p  
**Market cap** £163m

Net cash (£m) at 30 September 2021	52.1
Shares in issue	440.1m
Free float	69%
Code	MERC
Primary exchange	AIM
Secondary exchange	N/A

## Share price performance



%	1m	3m	12m
Abs	(1.3)	(9.2)	52.6
Rel (local)	0.7	(10.0)	36.7
52-week high/low		43.25p	23.60p

## Business description

Mercia Asset Management is a regionally focused specialist asset manager. Its stated intent is to become the leading regional provider of supportive balance sheet, venture, private equity and debt capital in transaction sizes typically below £10m.

## Next event

FY22 results	July 2022
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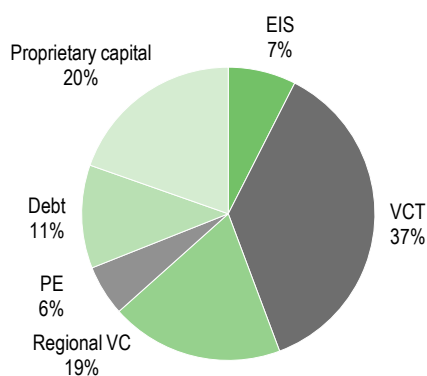
**Mercia Asset Management is a research client of Edison Investment Research Limited**

## H122 results

### Fund returns omit investor distributions

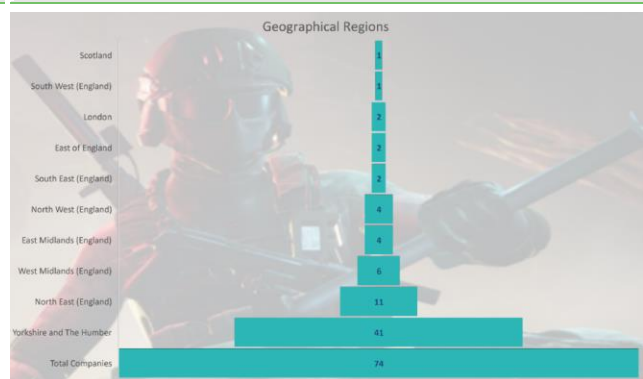
AUM remained fairly flat at £948m in H122 (FY21: £940m), although still up 9% y-o-y (H121: £872m). However, this does not take account of distributions to investors in Mercia's various funds, which totalled £39m in the period (H121: £4m) from nine successful exits. Third-party FUM were also largely unchanged in H122 at £762m (FY21: £764m), although up 6% y-o-y, with £38m of the overall £39m of investor distributions falling to third-party fund investors. Although these distributions do not flatter Mercia's top line, they will be well received by investors and clearly strong returns are likely to encourage investors to consider investing further funds through Mercia.

**Exhibit 1: H122 AUM breakdown**



Source: Mercia Asset Management

**Exhibit 2: H122: 74 deals completed across all funds**



Source: Mercia Asset Management

Of FUM, 83% of funds are committed to various stages of venture (EIS, VCT, VC and proprietary capital) (Exhibit 1), with private equity (6%) and debt (11%) the remainder.

In June 2021, Mercia received a further £5m from the British Business Bank for the Midlands Engine early-stage proof of concept fund, together, post period-end, with £26m for the Northern Powerhouse activities (£15m equity, £11m debt). Exhibit 2 provides a further breakdown of Mercia's funds, highlighting the investment criteria that apply to each asset class, the relative breadth of the portfolios and showing total liquidity across the group of c £284m.

**Exhibit 3: Fund breakdown at September 2021**

	National VCT/EIS	Regional venture	Private equity	Debt	Proprietary capital
Investment criteria:	Early stage, series A, up to £5m	Early stage, up to £2m	Profitable, up to £5m	Profitable, up to £1m	Series A, up to £5m
Total portfolio size:	128	125	9	164	23
Investments made this period:	£24m	£14m	£5m	£7m	£5m
New to portfolio:	5	6	1	26	-
AuM:	£420m	£181m	£53m	£108m	£186m
Cash:	£121m	£38m	£19m	£54m	£52m

Source: Mercia Asset Management

Excluding the impact of performance fees (H122: £2.6m gross, £1.6m net, H121: nil), group revenues increased 21% in H122 to £10.1m (H121: £8.4m). In total, 96% of revenues came from fund management fees, with 88% of revenues contracted and recurring. Administrative expenses (excluding performance fees) increased by 9% to £8.0m (H121: £7.3m), despite headcount growth

of c 17% to 106 people since the first lockdown in March 2020, meaning revenues more than covered central costs in the period. With further recruitment, administrative costs are expected to accelerate in H222.

PAT rose by 35% to £11.2m in H122 (H121: £8.2m), including the net performance fees, with EPS also increasing by 35% to 2.53p (H121: 1.87p). This strong performance left the group with cash and short-term liquidity investments of £52m (FY21: £55m), part of which we expect to be deployed towards M&A in 2022.

### Tripled interim dividend, we estimate a c 2% FY22e dividend yield

Following the strong first-half performance, confidence in the sustainability of Mercia's hybrid investment model, together with the group's good liquidity position, has enabled the board to declare a tripling of the interim dividend to 0.3p per share (H121: 0.1p). Assuming a more conservative uplift in the final dividend for FY22 than was seen in FY21, we estimate that Mercia might offer a prospective FY22 dividend yield of c 2% as part of a progressive dividend policy.

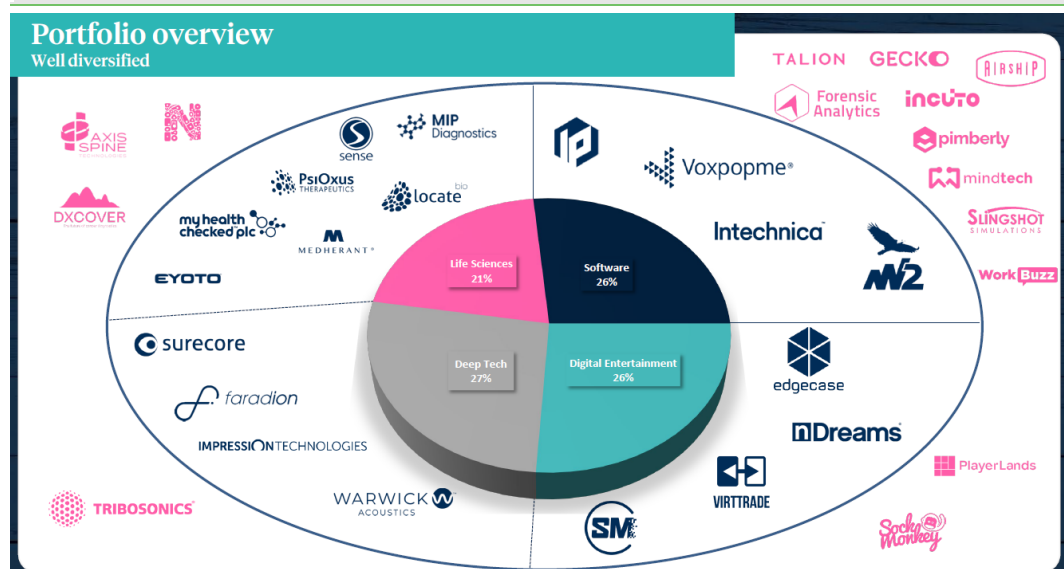
### 8% rise in hard NAV to £162m in H122

Net assets rose 6% during the period to £186.4m (FY21: £176.0m), with unrestricted cash and short-term liquidity investments of £52.1m (FY21: £54.7m) and total liquidity across the group of c £284m. Hard NAV (portfolio fair value plus net cash) rose by 8% to £162.4m in H122 (36.9p per share) from £150.9m (34.3p per share) in FY21 and net assets per share rose by 6% to 42.4p (FY21: 40.0p) over the period.

### Direct investment portfolio

The value of Mercia's direct investment portfolio at H122 period-end rose to £110m, an increase of 15% over FY21 (£96m), with Mercia investing £5.4m (net) into five portfolio companies (Faradion, Medherant, Locate Bio, VirTrade and Eyoto) (H121: £10.9m net, 14 portfolio companies), together with net fair value gains during the period of £8.7m (H121: £6.7m).

**Exhibit 4: A balanced portfolio with an identified shadow portfolio**



Source: Mercia Asset Management

As can be seen in Exhibit 4, the group has a balanced portfolio spread across four sectors: life sciences, software, deep tech and digital entertainment. As well as 23 existing direct investments at period end, management has identified a further 12 companies in Mercia's 'shadow portfolio' (following post period-end investments in Forensic Analytics and Pimberly) from the broader fund

portfolio, that Mercia is tracking closely and may become future direct investments. Management anticipates a maximum portfolio size of c 30 investments.

We have interviewed the two games company CEOs in Mercia's top 10 holdings, nDreams and Soccer Manager (Exhibits 5 and 6), to get more insight into their businesses, discussing the impact of lockdown and the metaverse to try to understand where these businesses might be headed next.

**Exhibit 5: Patrick O’Luanaigh, nDreams**



Source: Edison Investment Research

**Exhibit 6: Andy Gore, Soccer Manager**



Source: Edison Investment Research

### Top 10 direct holdings represent 81% of portfolio fair value

In line with previous reporting periods, Mercia's top 20 direct investments represented 98% of total portfolio value at 30 September 2021, with the top 10 representing 81% of total portfolio value.

Mercia weights its efforts accordingly.

**Exhibit 7: Direct investment portfolio at 30 September 2021 (£'000s)**

Holding	Year of first direct investment	Net value 1/4/21	Net cash invested H122	Fair value change H122	Net value 30/9/21	% held at 31/3/21	Holding as % of total portfolio fair value	Cumulative % of total
1 nDreams	2014	17,726	-	-	17,726	35.4	16.1	16
2 Faradion	2017	5,693	1,500	5,756	12,949	15.0	11.7	28
3 Intechnica	2017	9,996	-	2,824	12,820	27.5	11.6	39
4 Medherant	2016	8,105	534	349	8,988	33.1	8.1	48
5 Voxpopme	2018	8,845	-	-	8,845	17.6	8.0	56
6 Impression Technologies	2015	8,622	-	-	8,622	67.3	7.8	63
7 Ton UK (Intelligent Positioning)	2015	4,913	-	-	4,913	29.9	4.5	68
8 Locate Bio	2018	3,006	1,664	188	4,858	18.1	4.4	72
9 Warwick Acoustics	2014	4,255	-	407	4,662	35.8	4.2	77
10 Soccer Manager	2015	3,553	-	1,047	4,600	39.0	4.2	81
11 VirtTrade	2015	2,812	796	148	3,756	40.0	3.4	84
12 Eyoto	2017	1,813	750	-	2,563	15.7	2.3	86
13 sureCore	2016	2,417	-	-	2,417	22.0	2.2	89
14 PsiOxus Therapeutics	2015	2,407	-	-	2,407	1.4	2.2	91
15 Edge Case Games	2015	2,300	-	-	2,300	18.7	2.1	93
16 W2 Global	2018	2,300	-	-	2,300	16.3	2.1	95
17 MyHealthChecked	2016	4,488	-	(2,448)	2,040	13.5	1.8	97
18 Sense Biodetection	2020	945	-	625	1,570	1.2	1.4	98
19 MIP Diagnostics	2020	302	-	-	302	3.3	0.3	98
20 LM Technologies	2015	250	-	(250)	-	48.3	-	98
Other direct investments	-	1,472	126	62	1,660	-	1.5	100
<b>Total</b>	<b>-</b>	<b>96,220</b>	<b>5,370</b>	<b>8,708</b>	<b>110,298</b>	<b>-</b>	<b>100</b>	<b>100</b>

Source: Mercia Asset Management

Management reported commercial progress has continued to be made by the majority of the direct investment portfolio including each of the top five direct investments, with in-bound interest noted on the analyst call in each of the top three holdings. Eight direct holdings saw a fair value upgrade in H122, with one valuation reduced as its publicly traded share price fell, as well as full provision made for a smaller holding at period-end.

Of the top 10 portfolio companies within the direct investment portfolio, driven by significant commercial progress, Faradion (sodium-ion batteries) saw the largest rise in valuation (£5.8m), along with Intechnica (SaaS technical services, £2.8m); Soccer Manager (mobile football management game, £1.0m) also made progress. At the other end of the spectrum, the publicly traded share price of MyHealthChecked (COVID-19 travel tests, £2.4m write-down) has remained under pressure and LM Technologies was fully provisioned (a key enabler of the internet of things with its products assembled in China, £0.3m write-down).

The value of Mercia's top 10 holdings increased by 19% over the six months since 31 March 2021. There were no exits from the direct portfolio during H122.

## **Outlook: Organic growth to be supported by M&A**

Management has set out its strategic goals for 2022–24 in its Mercia 20:20 vision, including average annual growth in AUM of 20% over the period (closing AUM of £1.6bn by FY24) and average PBT of £20m per year, or total PBT of £60m over the three-year period.

Growth in AUM will be driven by returns from investment into new and existing direct holdings which are intended to contribute to the £60m of PBT targeted between FY22-24, as well as growth in FUM. Management intends to increase the size of its equity holdings, taking direct investment stakes of at least 10% in a diversified portfolio of up to 30 companies (versus 23 at 30 September 2021). The group also intends to grow FUM organically, including providing seed funding for the launch of new funds, as well as through M&A.

If Mercia can achieve these strategic objectives, we anticipate it would likely lead to further substantial share price gains over the next three years.

## **Increasing prospect for further M&A in 2022**

Mercia has delivered a direct investment portfolio IRR of 14% from its IPO in 2014 to 30 September 2021, as well as annual growth in NAV per share of over 24% over the last two years, following completion of the acquisition of the Northern VCT fund management business.

Since their acquisition, the Northern VCT funds have raised £38m of new capital to 30 September 2021 (with a further £40m fund raise targeted), have delivered 13 exits and eight cross-referred investments, together with £6.1m of performance fees paid to Mercia (including £2.6m of gross performance fees received in H122).

With a cash-generative model and £52m of unrestricted net cash on the balance sheet as at 30 September 2021, management has indicated it will look to supplement organic growth with M&A around the group's core and/or complementary competencies. Having demonstrated the success of the acquisition of the Northern VCT funds in 2019 (and Enterprise Ventures Group in 2016), we believe Mercia has the means and the rationale to target further M&A in 2022, without recourse to the markets.

## **Valuation: 0.87x NAV, 7.3x annualised P/E, c 2% yield**

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As a specialist fund manager, Mercia's financial performance centres around the growth in fair value of its direct investment portfolio on its balance sheet, together with the growth in FUM and the predictable, recurring management fees that results. Mercia is unusual in that its fee income more than covers central costs, meaning it can point to a growing stream of both post-tax profits and dividends.

Sector valuations have fallen recently with renewed concerns over rising interest rates, high technology valuations and growing unease over the Omicron variant of COVID-19. However, in a more challenged investment scenario, Mercia's model has identifiable downside protection, with its

broad regional footprint offering an investment portfolio diversified both across asset class and sector, and a model that is both sustainably profitable and dividend generating.

**Exhibit 8: Quoted peer group**

	Price	Currency	Market cap (£m)	Last NAV reported (£m)	Net cash/ (debt) (£m)	NAV per share (p)	NAV premium/ discount
Mercia Asset Management	37.0	GBp	163	186	52	42.4	0.87
<b>Specialist asset managers</b>							
Gresham House	895.0	GBp	340	102	(2)	307.8	2.91
Intermediate Capital Group	2173.0	GBp	6,290	1,752	(1,097)	609.0	3.89
						<b>Mean</b>	<b>3.40</b>
<b>Direct investors</b>							
Augmentum Fintech	158.3	GBp	285	267	44	142	1.11
Forward Partners	108.5	GBp	146	102	37	104	1.04
HgCapital Trust	419.0	GBp	1,892	1,850	(101)	415	1.01
IP Group	118.0	GBp	1,231	1,439	249	135	0.87
Molten Ventures	926.0	GBp	1,417	1,357	156	887	1.04
Oakley Capital Investments	373.5	GBp	667	804	172	445	0.84
TMT Investments	7.05	USD	222	237	41	7.49	0.94
						<b>Mean</b>	<b>0.98</b>
						<b>Median</b>	<b>1.01</b>

Source: Company accounts, Refinitiv. Note: Priced at 13 December 2021.

Mercia trades on an H122 NAV of 0.87x, before considering the incremental value of the third-party funds business (we estimate an additional 7p per share at 4% of FUM), towards the bottom of our field of direct investment peers, which largely trade between 0.8x and 1.2x NAV. However, when we look at specialist asset managers such as Gresham House and Intermediate Capital Group, these trade at multiples of NAV as their valuation is increasingly referenced to earnings multiples. Mercia trades on a P/E of 7.3x annualised H122 EPS (vs average FY21/22 P/E multiples for Gresham House and ICG of 19x and 18x, respectively). After the trebling of its interim dividend, we estimate that Mercia might offer a prospective FY22 dividend yield of c 2%, assuming a more conservative uplift in the final dividend for FY22 than in FY21.

Given the strength of Mercia's business, its structural profitability and underlying operating model, we believe Mercia remains undervalued at these levels.

### Funds business: 7p per share uncaptured value on top of NAV

Thanks to the fees it charges on its third-party managed funds (c 2% of AUM), of which c 88% are contracted and recurring, Mercia is structurally profitable and dividend generating. An NAV-based valuation fails to capture the incremental value of this fund management business within Mercia, which represents an ever-widening gap as FUM increases.

We continue to estimate the value of Mercia's embedded fee-earning funds business at 4% of FUM (a conservative valuation considering Mercia's attractive fee margins) on top of the NAV-based valuation of its direct investment business. With last reported FUM of £762m, this implies a valuation for the funds business of c £30m, or 7p per share on top of the H122 NAV of 42.4p per share, implying a hybrid valuation of 49.4p per share.

**Exhibit 9: Financial summary**

31-March	£'000	2017	2018	2019	2020	2021
<b>INCOME STATEMENT</b>						
Revenue		6,660	10,197	10,675	12,747	23,410
Cost of Sales		(92)	0	0	0	0
Gross Profit		6,568	10,197	10,675	12,747	23,410
Operating costs		(9,051)	(10,633)	(12,115)	(12,661)	(16,554)
Adjusted operating profit/(loss)		(2,221)	(81)	(794)	518	3,337
Fair value changes		4,268	2,823	3,916	(15,844)	9,723
Realised gains		839	871	0	0	20,251
Normalised operating profit		2,624	3,258	2,476	(15,758)	36,830
Amortisation of acquired intangibles		(301)	(301)	(301)	(852)	(2,317)
Exceptionals		(1,125)	(1,125)	0	(695)	0
Share-based payments		(395)	(497)	(171)	(528)	(543)
Reported operating profit		803	1,335	2,004	(17,833)	33,970
Net Interest		186	274	562	220	48
Profit Before Tax (norm)		2,810	3,532	3,038	(15,538)	36,878
Profit Before Tax (reported)		989	1,609	2,566	(17,613)	34,018
Reported tax		54	54	54	159	440
Profit After Tax (norm)		2,810	3,532	3,038	(15,538)	36,878
Profit After Tax (reported)		1,043	1,663	2,620	(17,454)	34,458
Net income (normalised)		2,810	3,532	3,038	(15,538)	36,878
Net income (reported)		1,043	1,663	2,620	(17,454)	34,458
Basic average number of shares outstanding (m)		224	302	303	341	440
EPS - basic normalised (p)		1.26	1.17	1.00	(4.55)	8.38
EPS - diluted normalised (p)		1.21	1.13	1.00	(4.55)	8.38
EPS - basic reported (p)		0.47	0.55	0.86	(5.11)	7.83
Dividend (p)		0.00	0.00	0.00	0.00	0.40
Revenue growth (%)		279.5	53.1	4.7	19.4	83.7
Gross Margin (%)		98.6	100.0	100.0	100.0	100.0
Normalised Operating Margin		39.4	32.0	23.2	-123.6	157.3
<b>BALANCE SHEET</b>						
Fixed Assets		63,693	77,428	98,724	124,899	131,171
Intangible Assets		11,514	11,213	10,912	36,705	34,388
Tangible Assets		151	145	153	125	107
Right of use assets		0	0	0	598	456
Investments		52,028	66,070	87,659	87,471	96,220
Current Assets		64,576	53,965	31,180	31,951	61,269
Debtors		747	1,057	782	1,298	4,060
Unrestricted cash		28,829	42,908	24,581	23,971	54,491
Restricted cash		4,228	3,473	629	467	2,484
Short term liquidity investments		30,772	6,527	5,188	6,215	234
Current Liabilities		(6,698)	(7,760)	(3,730)	(6,659)	(9,827)
Creditors		(6,698)	(7,760)	(3,730)	(4,805)	(8,127)
Lease liabilities		0	0	0	(118)	(122)
Short term borrowings		0	0	0	0	0
Other (incl deferred consideration)		0	0	0	(1,736)	(1,578)
Long Term Liabilities		(217)	(163)	(109)	(8,731)	(6,592)
Long term borrowings		0	0	0	0	0
Lease liabilities		0	0	0	(473)	(351)
Other long term liabilities		(217)	(163)	(109)	(8,258)	(6,241)
Net Assets		121,354	123,470	126,065	141,460	176,021
Minority interests		0	0	0	0	0
Shareholders' equity		121,354	123,470	126,065	141,460	176,021
NAV per share		40.37	40.71	41.56	32.14	39.99
<b>CASH FLOW</b>						
Op Cash Flow before WC and tax		2,624	3,258	2,476	(15,758)	36,830
Depreciation and amortisation		76	81	84	212	212
Gain on sale of direct investments		(839)	(871)	0	0	(20,251)
Fair value movements in direct investments		(4,268)	(2,823)	(3,916)	15,844	(9,723)
Working capital		5,250	(87)	(3,724)	695	(1,457)
Exceptional & other		0	0	0	(695)	0
Tax		0	0	0	0	0
Net operating cash flow		2,843	(442)	(5,080)	298	5,611
Capex		(82)	(75)	(92)	(45)	(52)
Acquisitions/disposals		3,049	10,618	1,711	(12,400)	(2,100)
Net interest		165	260	531	245	68
Direct investments		(11,828)	(21,282)	(19,384)	(15,656)	21,590
Equity financing		38,750	0	(196)	30,000	0
Dividends		0	0	0	0	(440)
Other		(25,000)	25,000	4,812	(3,052)	5,843
Net Cash Flow		7,897	14,079	(17,698)	(610)	30,520
Opening net debt/(cash)		(20,932)	(28,829)	(42,908)	(24,581)	(23,971)
Other non-cash movements		0	0	(629)	0	0
Closing net debt/(cash)		(28,829)	(42,908)	(24,581)	(23,971)	(54,491)
Closing net debt/(cash) inc short-term liquidity investments (not EIS)		(59,601)	(49,435)	(29,769)	(30,186)	(54,725)

Source: Mercia Asset Management accounts.

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